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SUBJECT: CYPRUS ON TRACK TO ADOPT EURO ON JANUARY 1, 2008

(U) This cable is sensitive but unclassified. Please treat accordingly.

11. (SBU) Summary.

The Cypriot economy continues to perform well within the Maastricht criteria, and the European Union is expected in June 2007 to invite Cyprus to adopt the Euro as its currency effective January 1, 2008. The European Commission, however, has criticized the GoC's technical preparations for the transition for lacking detail and has urged Cyprus to be more proactive in addressing public fears over expected price increases. The latest Eurobarometer poll showed 58 percent of Cypriots "very or rather unhappy" about losing the Cypriot pound, compared to 52 percent in April. A public information campaign, however, has been delayed until at least January as unsuccessful bidders for the lucrative contract have challenged the results of the tender.

12. (SBU) The communist AKEL party, the largest party in the governing coalition, continues to make occasional noises about the desirability of delaying Euro adoption for a year. This, however, is widely dismissed as political posturing, and the Council of Ministers (including those Ministers appointed by AKEL) continues to unanimously back the January 1, 2008 target date. The adoption of the Euro will remove any debate over what currency a future united Cyprus should use, removing at least one of the many contentious issues that help keep Cyprus divided. While some in the Turkish Cypriot community have suggested that the north should simultaneously adopt the Euro, this has received little support from the Turkish Cypriot authorities, Turkey, or even the EU. That said, retailers in the north will gladly accept Euros, Cypriot and British pounds, or any hard currency rather than Turkish lira. End Summary.

Euro Adoption in 2008 "now a near certainty"

13. (SBU) The latest Economist Intelligence Unit report on Cyprus noted that Cypriot adoption of the Euro on January 1, 2008 is "now a near certainty." Senior Cypriot officials remain very confident that, barring any unexpected sharp increase in fuel prices, inflation can be kept under control, and Cyprus will continue to meet all the prerequisites necessary to qualify for Euro adoption. These prerequisites are known commonly as the Maastricht criteria.

¶4. (SBU) Finance Minister Michalis Sarris told us that Cyprus will formally apply for Eurozone membership only in February, honoring Economic and Monetary Affairs Commissioner Almunia's request to allow more time for Malta to catch up. The European Commission will then prepare a recommendation that will be considered first by the European Council's Economic and Financial Committee and then by ECOFIN. A final invitation will need to be endorsed by the Parliament and EU Heads of State. Finance Minister Sarris told the Ambassador that he hoped to have the whole process wrapped up at the June 2007 European Council meeting. Central Bank officials told us that Cyprus frequently has asked for and received assurances from the EU that Cyprus's adoption of the Euro will not be delayed should Malta prove unready, and that each country will be allowed to go at its own pace.

Cyprus Comfortably Meeting All Five Maastricht Criteria

¶5. (SBU) Rapid adoption of the Euro has been the main economic priority of the Papadopoulos Administration and has led to a degree of fiscal discipline previously unheard of in Cyprus. Supported by strong economic growth of nearly 4 percent annually since 2004, the GoC has succeeded in cutting its budget deficit from over 6 percent of GDP in 2003 to an estimated 2 percent in 2006 -- well below the Maastricht criterion of 3 percent or less. The GoC has also significantly cut its national debt from 72 percent of GDP in 2004 to 65 percent in 2006. (Note: The Maastricht criterion requires 60 percent of GDP or a "sufficiently declining trend." While there is no clear definition of what "sufficiently declining" means, Cypriot Central Bank officials tell us that Commission officials assure them that Cyprus meets it. End note.)

¶6. (SBU) At present, Cyprus is also comfortably meeting the Maastricht criteria for inflation (being under 1.5 percentage points above the average of the Eurozone's three best performers) and interest rates (having the interest rate on ten-year bonds plus two percentage points fall below the average ten-year interest rate of the Eurozone's top three inflation performers). Cyprus's current rolling 12-month inflation rate of 2.3 percent easily falls below the current Maastricht reference rate of around 2.7 percent, as does Cyprus's 4.2 percent long-term interest rate (compared to the current Maastricht reference value of 6.1). On May 2, 2007, Cyprus will have also completed the necessary two years within the Exchange Rate Mechanism II (ERM II). So far, Cyprus has successfully maintained its parity of 0.585274 Cypriot pounds to the Euro well within the permitted band of 2.5 percent either way.

Concern Over Pace of Technical Preparations

¶7. (SBU) While the European Commission has applauded Cyprus's progress toward meeting the Maastricht criteria, it has not been shy to criticize the GoC's technical preparations for the transition to the Euro. The GoC envisages a "big bang" scenario with a dual circulation period for both the euro and the Cyprus pound for a period of one month after January 1, 2008. Commercial banks will exchange Cyprus pound banknotes and coins free of charge until June 30, 2008. The Central Bank will exchange national coins free of charge until the end of 2009 and national banknotes until the end of 2017. Dual pricing in Cypriot pounds and Euros will be mandatory from September 1, 2006 until July 31, 2008. Though utilities and large retailers are displaying both currencies, few of the ubiquitous small businesses are doing so. Central Bank Officials expect that the final rate at which the Cypriot pound will be converted to the Euro will be set in May 2007. Cyprus has also been receiving technical assistance from the Governments of Ireland and Greece.

¶8. (SBU) In its regular, bi-annual Convergence Report, dated November 10, 2006, the European Commission criticized Cyprus's changeover plan for being short on detail, especially on issues such as distributing Euros to commercial operations prior to the changeover and how to handle the backflow of national cash. It also warned that a relatively protracted period of free exchange of Cyprus pounds by commercial banks sent an ambiguous message to consumers, thus risking a prolonged changeover. Central Bank officials blame some of the criticism on a bureaucratic error that led to an outdated report being sent to Brussels, but assured us the GoC was taking the criticism seriously. They noted, however, that, unlike in Malta where government officials had been assigned to

coordinate Euro adoption full-time, Cyprus had opted for a large number of inter-agency committees. Government officials were expected to serve on these committees in addition to their regular jobs, causing concern that this might lead to bureaucratic inertia and unnecessary delays.

¶9. (U) For more information on the changeover plans please see Cyprus's Euro website at www.euro.cy and the EU's fourth report on the practical preparation for the future enlargement of the euro area available at: http://ec.europa.eu/economy_finance/publications/euro_related/2006/eurorelated_enlargement_euroarea_en.htm

Public Skepticism

¶10. (SBU) But by far the European Commission's biggest concern has been the growing skepticism of the Cypriot public toward the Euro. A recent Eurobarometer poll showed that the percentage of Cypriots "rather unhappy" or "very unhappy" about the planned change from the Cypriot pound to the Euro had grown six percentage points (to 58 percent) since April. Almost all Cypriots have friends or family in Greece who have told them horror stories about Greece's difficult transition. Most Cypriots appear convinced that adoption of the Euro will lead to an acceleration of prices and have little appreciation of the benefits involved.

¶11. (SBU) A planned government information campaign designed to address these fears, however, has been slow to get off the mark. The Finance Ministry's award of a CYP one million (USD 2.3 million) contract to a private firm, Epistele, to help launch the public information campaign has been shrouded in controversy. Three of the losing firms, including Marketway, which is owned by the wife of the Foreign Minister, obtained a court order to delay signing of the contract until at least December 28. There are also press allegations that Epistele is a front company for Marketway.

¶12. (SBU) Cyprus's largest political party and largest member of the governing coalition, the Communist AKEL, has also been questioning the timeline for Euro adoption. Arguing that fiscal discipline should be relaxed in favor of increased social spending, AKEL has proposed delaying Euro adoption until at least 2009. Analysts universally dismiss this as political posturing, and note that the Council of Ministers, including those Ministers appointed by AKEL, unanimously adopted and continue to support the January 1, 2008 goal. Nevertheless, AKEL's public stance is doing little to help increase public confidence in the new currency.

Economic Benefits of EU Adoption

¶13. (SBU) Despite AKEL's criticisms and the public's fears, the GoC remains firmly behind adopting the Euro in January 2008. Central Bank officials have noted to us the tremendous benefits of Euro adoption for a small country like Cyprus, including a higher degree of price stability, lower interest rates, reduction of currency conversion costs and exchange rate risk, and increased competition through greater price transparency. Giving up the ability to pursue an independent monetary or exchange-rate policy is not that big a sacrifice, they note. Cyprus never used the latter and any graph of Cyprus's business cycles would closely mimic that of the EU as a whole.

Political Benefits of Euro Adoption

¶14. (SBU) Even Finance Minister Sarri has noted publicly that Cypriot adoption of the Euro should make resolution of the seemingly intractable Cyprus issue a bit easier by removing any doubt over which currency would be used in any future united Cyprus. What currency to use and how to handle the transition were two of the many contentious issues within the controversial Annan settlement plan.

¶15. (SBU) Suggestions, however, that the Turkish Cypriot community should simultaneously adopt the Euro as well on January 1, 2008, have gained little support among the Turkish Cypriot or Turkish leadership or even the EU, despite significant economic (and political) advantages. For instance, over the past three decades, high interest rates and the lack of a stable currency have been major impediments to economic growth. Turkish Cypriot adoption of

the Euro is seen by many as a political rejection of Turkey, which supplies roughly USD 450 million a year in aid to the north -- including directly subsidizing a third of the "TRNC's" budget. It would also mean that any future aid would require Turkey to use its foreign exchange reserves, lessening the likelihood that Turkey would continue being quite so generous. While the long-term advantages to the north's development of removing the "TRNC's" soft budget constraint are significant, this is not a step that either Turkey or the Turkish Cypriot community appear ready to make.

¶16. (SBU) The EU -- the Turkish Cypriot community's second largest aid donor with a 259 million Euro, multi-year aid program -- also appears to oppose adopting the Euro in the north prior to a settlement. Although technically he would not be able to stop it, Economic and Monetary Affairs Commissioner Almunia is reportedly on record as opposing Euro adoption by any entity that has not gone through the Maastricht criteria process, including the Turkish Cypriot community. (Note: While all of Cyprus, including the north, is technically part of the EU, the EU has suspended the *acquis* in

the area administered by the Turkish Cypriots -- i.e., the area outside of the effective control of the Government of Cyprus. End note.)

American Co-designs Cypriot Euro Coins

¶17. (U) At a recent ceremony, the Central Bank unveiled the winning designs for the national side of the Cypriot euro coins. The winning artists were a two-person design team consisting of an American and Greek Cypriot couple.

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